CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY

FOR
DOLLAR-DENOMINATED SHORT-TERM PROGRAM –
INTERNALLY MANAGED

August 16, 2004

This Policy is effective immediately upon adoption and supersedes all previous internally managed dollar-denominated short-term fund investment policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Internally Managed Dollar Denominated Short-term Fund Investment Program ("the Program"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling risks and capturing returns associated with this segment of the market.

II. STRATEGIC OBJECTIVE

Ensuring that the System has liquidity adequate to meet its projected cash flow needs, while at the same time keeping its cash balances (including those managed for the System's external managers) fully invested, so as to achieve the highest total rate of return possible consistent with a prudent level of risk, is the strategic objective of the Program. The Program shall be managed to exceed the total rate of return of the State Street Bank Short Term Investment Fund (SSB STIF) while maintaining a high level of liquidity and diversification.

The Program shall be managed to accomplish the following:

A. Provide liquidity to the System;

B. Enhance the System's total rate of return by ensuring that all cash balances are fully invested at all times until they are needed by the System; and

C. Consider solely the interest of the System's participants and their beneficiaries in accordance with California State Law.

III. RESPONSIBILITIES AND DELEGATIONS

A. The **System's Investment Committee** ("the Investment Committee") is responsible for approving and amending the Policy and delegates the responsibility for administering the Program to the Investment Staff through the Delegation of Authority (Delegation Nos. 89-13 and 95-50).

B. The **System's Investment Staff's** ("the Staff") duties include, but are not limited to, the following:

1. Developing and recommending the Policy to the Investment Committee;

2. Maintaining a procedures manual which is subject to periodic review and updating that outlines staff operational procedures used in implementing this Policy;

3. Implementing and adhering to the Policy;

4. Reporting immediately to the Investment Committee all violations of the Policy with explanations and recommendations;

5. Purchasing only securities permitted in the Policy; and

6. Reporting to the Investment Committee at least quarterly concerning the following:

   a. Weighted-average days to maturity;

   b. Portfolio allocation by asset type and ratings; and

   c. An exceptions report that covers Policy violations.

7. Reporting internally to senior management concerning the implementation of this Policy. The Staff shall prepare this report monthly, with information to include, but is not limited to following issues:

a. Weighted-average days to maturity;

b. Portfolio allocation by asset type and ratings; and

c. An exceptions report that covers Policy violations.

C. The **General Pension Consultant** is responsible for monitoring, evaluating, and reporting to the Investment Committee, at least quarterly, the performance relative to the benchmark and Policy guidelines. The General Pension Consultant is responsible for reporting non-compliance in accordance with its responsibilities under its contract with the System. Monitoring shall include placing the Manager on Watchlist or Probation Status using the following criteria:

1. **Watchlist Status: Placement on Watchlist Status will occur during** a period of two consecutive quarters, when the manager's "value relative ratio" is between ninety-five percent (95%) and ninety-eight percent (98%).

   The "value relative ratio" depicts the Portfolio as a percentage of the benchmark. When the benchmark and the portfolio are equal, the ratio is 1.00 (one). At a ratio of 1.00, the manager is not adding value over an indexed portfolio represented by the benchmark. When the portfolio return is below (above) the benchmark, the ratio is less (greater) than 1.00.

2. **Probation Status: Placement on Probation Status will occur when** the Manager's "value relative ratio" is 95% or less for two quarters. If the Manager is already on Watchlist, then one quarter of a 95% or less "value relative ratio" would replace the Manager on Probation.

IV. INVESTMENT APPROACHES AND PARAMETERS

A. Investment Approach

The goals of the Program are to provide liquidity to the System and to maximize investment returns at a prudent level of risk. The investment approach is to identify opportunities in the short end of the yield curve and invest where risks are understood and manageable, while maintaining liquidity, credit quality, weighted-average days to maturity, and diversification as specified in this Policy.

To ensure liquidity, all Program investment transactions shall be made in conjunction with the System's projected cash flow needs (see Investment Policy Manual Section XIII, A, 1,c).

B. **Specific Risk Parameters**

The System shall manage the following major categories of short-term risk:

1. **Benchmark risk** addresses whether the SSB STIF is the appropriate reference point for the Program.

2. **Liquidity risk** is the ease with which a security can be sold at or near prevailing market prices. Liquidity risk shall be managed within the context of the System's projected cash flow needs.

3. **Interest rate risk** is the price volatility produced by changes in the overall level of interest rates as measured by a fund's weighted-average days to maturity. Decisions shall be managed in a controlled manner using economic analysis, Federal Open Market Committee analysis, and projected cash flow requirements of the System. All securities purchased shall have a maximum final stated maturity of 15 months **except** for the following securities:

   a. Callable securities having a high probability of being "called" as projected using option-adjusted and scenario analysis. Callable securities shall have a maximum anticipated maturity to call of 12 months.

   b. Fixed rate asset-backed securities shall have a maximum projected average life of 15 months and a final stated maturity that does not exceed five years.

   c. Floating rate asset-backed securities shall have a maximum projected average life of 3 years and a final stated maturity that does not exceed five years.

   d. Corporate and U.S. Government Agency floating rate securities shall have a final stated maturity not exceeding three years.

   e. Securities with short-term ratings that are split-rated shall have a maximum final stated maturity of 120 days (including floating rate securities).

f. Securities rated A2/P2 shall have a maximum final stated maturity of 75 days (including floating rate securities).

g. Deliveries versus payment repurchase agreements (DVP Repo) are limited to a maximum of 14 days from the trade date to the date of repurchase.

h. Investments in short-term obligations of issuers domiciled outside the United States shall have a maximum final stated maturity of 120 days.

4. **Yield curve risk** is the price change induced by the changing slope of the yield curve. Yield curve risk shall be managed in a controlled, disciplined fashion by employing break-even and economic analysis.

5. **Credit risk** is the uncertainty surrounding the borrower's ability to repay its obligations. Credit risk shall be managed with a goal of zero defaults. A down-grading of a security, which causes a violation of the Policy, shall not require an immediate sale if the Principal Investment Officer of Fixed Income believes that no further risk of credit deterioration exists, or that the sale diminishes the total rate of return to the System. The internal research staff and the external rating agencies shall be utilized in analyzing such situations to ensure that an informed decision is made. The following are minimum credit quality standards for each of the sectors:

   a. **U.S. Treasury & U.S. Government Agency securities** shall have a credit quality rating of AAA.

   b. **Asset-backed securities** must be in the highest rating category for short-term debt obligations (A1+/P1 or A1/P1) or rated on a long-term debt obligation basis by Moody's (Aaa) and Standard & Poor's (AAA).

   c. **Broker/dealer securities** must be in the highest rating category for short-term debt obligations (A1+/P1 or A1/P1).

   d. **Domestic money market securities** must be in one of the two highest rating categories for short-term debt obligations (A2/P2 or higher). If the security is only rated by one of the credit agencies (Standard & Poor's or Moody's) then the security must be in the highest rating category for short-term debt obligations (A1+, A1 or P1). All corporate issues with a short-term rating below A1/P1 shall be monitored by the internal research staff annually or as events warrant.

e. **Domestic corporate securities** (bonds, notes, medium term notes, and floating rate securities) without a short-term debt obligation rating must have a minimum long-term debt obligation rating by Moody's of A2 and by Standard & Poor's of A.

f. Investments in U.S. Dollar bonds and money market securities issued in the United States by foreign borrowers (Yankee) or U.S. Dollar bonds and money market securities issued outside the United States by domestic or foreign borrowers (Eurodollar) must be debt obligations of companies located in a country with a long-term sovereign rating by Moody's of Aa3 (or higher) and by Standard & Poor's AA- (or higher) and have a short-term rating of A1/P1 (or higher).

6. **Structure risk** arises from the options implicit in bonds (like callable and optional sinking fund bonds) or the rules governing cash flow that cause actual cash flows to differ from projected cash flows. Structure risk shall be managed using option adjusted and scenario analysis.

7. **Reinvestment risk** is the uncertainty concerning future yield opportunities and the reinvestment of funds that become available due to call, maturity, or coupon payments. Reinvestment risk shall be managed through call risk and cash flow analysis.

C. **Permissible Securities**

1. U.S. Treasury and U.S. Government Agencies including U.S. Treasury strips;

2. Publicly traded domestic corporate bonds, notes, and medium term notes;

3. Asset-backed securities collateralized by credit cards, automobile loans, or leases and agricultural equipment;

4. Publicly and privately traded domestic money market securities;

5. Floating rate securities tied to LIBOR, Fed Funds, Treasury bill and commercial paper indices;

6. State Street Bank Short Term Investment Fund (STIF);

7. DVP Repos;

8. Broker/Dealer Securities;

9. U.S. Dollar bonds and money market securities issued in the United States by foreign borrowers (Yankee); and

10. U.S. Dollar bonds and money market securities issued outside the United States by domestic or foreign borrowers (Eurodollar).

D. **Restrictions and Prohibitions**

1. Investments in a single issuer (including parent, subsidiary and guaranteed debt) whose securities are rated A1+/P1 or A1/P1, shall not exceed 10% of the Program over the holding period for such investments. However, holdings in such issuers with maturities in excess of 7 days shall not exceed 5% of the Program. For asset-backed securities, each separate trust (pool of assets) is defined as a separate issuer.

2. Investments in a single issuer (including parent, subsidiary and guaranteed debt) whose securities are split-rated (A2/P1 or A1/P2), shall not exceed 6% of the Program over the holding period for such investments. However, holdings in such issuers with maturities exceeding 7 days shall not exceed 3% of the Program.

3. Investments in a single issuer (including parent, subsidiary and guaranteed debt) whose securities are rated A2/P2, shall not exceed 4% of the Program over the holding period for such investments. However, holdings in such issuers with maturities exceeding 7 days shall not exceed 2% of the Program.

4. Aggregate investments in securities split-rated or A2/P2 shall not exceed 30% of the Program over the holding period for such investments.

5. Aggregate investments in floating rate securities shall not exceed 50% of the Program over the holding period for such investments.

6. Aggregate investments in fixed rate asset-backed securities shall not exceed 25% of the Program over the holding period for such investments.

7. Aggregate investments in DVP Repos with maturities exceeding the next business day shall not exceed 20% of the Program.

8. Tri-party repurchase agreements are prohibited.

9. Non-dollar denominated securities are prohibited.

10. Collateralized mortgage obligations and mortgage-backed securities are prohibited.

11. Financial futures and options are prohibited.

E. **Counterparty Exposure for DVP Repos**

1. The lesser of $200 million or 25 percent of the total Short-term Fund can be maintained with any one counterparty for DVP Repos.

2. The counterparty must be in the highest rating category for short-term debt obligations (A1+/P1 or A1/P1). Transactions shall be executed with only domestic brokers. The internal research staff shall actively review these brokers.

3. Collateral received on a repurchase agreement must consist of U.S. Treasury or U.S. Government Agency securities with a maximum final stated maturity of five years. All collateral must be marked-to-market on a daily basis and maintained at 102% of the amount of funds loaned plus accrued interest.

V. BENCHMARK

The benchmark is the total rate of return of the SSB STIF after investment management fees.

VI. GENERAL

A. Calculations and computations shall be on a mark-to-market or amortized cost method depending on market convention. Securities for which there are market quotations readily available shall be accounted for utilizing the mark-to-market method. When no market quote is available, the amortized cost method shall be used for determining the securities value.

B. For securities with periodic principal payments, the weighted-average days to maturity calculation shall be calculated from the evaluation date to the date of the security's average life.

C. For floating rate securities, the portfolio weighted-average days to maturity calculation shall be calculated from the evaluation date to the date of the next coupon reset.

D. References to short-term credit ratings shall be presented with Standard & Poor's rating first followed by Moody's (i.e., Standard & Poor's (A1) and Moody's (P1) shall be presented as A1/P1).

VII. GLOSSARY OF TERMS

The Fixed Income Glossary of Terms is referenced in the System's Master Glossary of Terms.